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No. 89-697

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

DOWNRIVER COMMUNITY FEDERAL CREDIT UNION and WOOD PRODUCTS CREDIT UNION,
Petitioners,

v.

PENN SQUARE BANK, through its Receiver, FEDERAL DEPOSIT INSURANCE CORPORATION,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

The Brief for the United States in Opposition ("Resp. Br.") fails to justify the court of appeals' sweeping encroachment on areas of law traditionally reserved by Congress and this Court for the states, and fails to diminish the patent conflict between the circuits which was created by the decision below. Both the opinion of the court of appeals (Pet. App. 1a-21a) and the Respondent's brief demonstrate a troubling willingness to upset a time-honored balance between state and federal interests under which state law determines the nature of pre-insolvency property interests. As shown below, the arguments advanced by the Respondent for ignoring the controlling precedents with which the opinion below conflicts are misleading and erroneous.

Contrary to the Respondent's suggestion (Resp. Br. 7-8), there is no conflict between the state law which created the Petitioners' constructive trusts and the ratable distribution requirement of the National Bank Act and, accordingly, there is no preemption of state law in this case.[1] The ratable distribution requirement applies only to the assets of national banks, not to assets of others held in trust by banks. The sole question is whether the Petitioners' trust funds were assets of Penn Square Bank when that bank failed. Absent express legislation by Congress, the pre-insolvency character of a national bank's assets is and always has been determined by state law.

The court of appeals and the Respondent address this gap in their analysis by arguing that the Petitioners are attempting to *change* their relationship with Penn Square Bank post-insolvency. Resp. Br. 8. To the contrary, the Petitioners are defending *against* such change. It is the FDIC as receiver who seeks to alter the Petitioners' pre-insolvency trustee/beneficiary relationship after insolvency. Whether a debtor/creditor or trustee/beneficiary relationship was created when Penn Square Bank fraudulently obtained the Petitioners' funds is a question of

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[1] Under the standard enunciated in *Davis v. Elmira Sav. Bank*, 161 U.S. 275, 283 (1896) and cited by Respondent (Resp. Br. 7-8), the conflict between state and federal law must be *express* in order for the federal law to preempt state law. In *Davis*, the Court held that state law was preempted where an express conflict existed between New York law, which provided that debts due to savings banks by insolvent banks were to be preferred over debts due to other creditors, and federal law, which provided for ratable distribution under the National Bank Act. Moreover, the Court explicitly distinguished the facts in *Davis* from situations where the relation was not that of an ordinary creditor, such as where by state law a lien is created apart from the insolvency, or where a creditor has a claim on a specific fund. 161 U.S. at 288-289. In those instances, since funds of the claimants are not assets of the bank, they are not subject to the requirement of ratable distribution. *Id.* Such is the case here.

state law. Under Oklahoma law, at the moment those funds were obtained by fraud, a constructive trust, not a debtor/creditor relationship, automatically arose. No intention by the parties to create a trust was required. The Respondent has cited absolutely no authority for the proposition that intention to create a trust is required to establish a constructive trust,[2] and no further action by the Petitioners was necessary to create that property right. By nature, a constructive trust arises irrespective of the intent of the parties. The relationship of trustee/beneficiary remained unchanged through the bank's failure and until the Tenth Circuit's decision.

The Respondent next argues that, regardless of the nature of a constructive trust as a vested property right under state law, a federal court can ignore such state law property rights because they are only an "equitable fiction . . . governed by federal law". Resp. Br. 8. Neither the court of appeals nor the Respondent has cited any support for such an audacious proposition, and as shown in the Petition, the proposition conflicts with the intention of Congress and the decisions of a number of other circuits. *See* Pet. 8-12 and 21-23 (discussion of conflicting decisions and Congressional statements of intent regarding constructive trusts and the role of state trust law for national banks). This attempt to downgrade the state law of trusts to a "fiction" would in effect overturn a century-long standard for determining

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[2] Respondent erroneously states that *Bank of Marin v. England*, 385 U.S. 99 (1966) stands for the proposition that "absent a showing of specific intent to the contrary, the relationship of a bank to its depositors is that of debtor and creditor founded upon contract." Resp. Br. 8. In fact, in *Bank of Marin*, the Court said *nothing* about the specific intent of the parties being required in order to establish a relationship other than that of debtor/creditor. The case did not involve an attempt to establish a relationship other than debtor/creditor between the bank and the depositor; it merely involved the question of whether the voluntary bankruptcy of the depositor (without notice to the bank) altered the obligations of the bank under the debtor/creditor contract to honor checks drawn by the depositor.

what property in the possession of a failed bank is actually an asset of that bank or is property belonging to another which the bank only holds in trust.

The Respondent's attempts to smooth out the clear conflicts created among the circuits by the decision below are erroneous and misleading. The Ninth Circuit in *Reno Nat'l Bank v. Seaborn*, 99 F.2d 482, 483 (9th Cir. 1938), unequivocally held that state law governed the question of the character of the assets prior to and at the time of insolvency and the question of whether the pre-insolvency conduct of a national bank had created a constructive trust prior to the bank's failure. *Reno Nat'l Bank* was not a case of federal preemption softened by the court's discretionary selection of state law as the rule of decision, as suggested by the Respondent.[3] Resp. Br. 10. The decision below remains in direct conflict with the Ninth Circuit, which would have applied state law in this case.

The conflict created with the Eighth Circuit remains equally unresolved. The Respondent's explanation of *Fiman v. South Dakota*, 29 F.2d 776 (8th Cir. 1928), *cert. denied*, 279 U.S. 841 (1929), has no relationship to the Eighth Circuit's actual reasoning in the case. The Respondent states that the *Fiman* court awarded the constructive trust because the depositor's claim was unique to that single depositor and its deposits had " 'been distinguished and pointed out as money belonging to the [depositor].' " Resp. Br. 10 (*quoting Fiman*, 29 F.2d at 783). The only distinction drawn in *Fiman* between the trust claimant and other depositors with potential con-

[3] Perhaps the most revealing aspect of the Respondent's analysis is its contention that, notwithstanding the fact that the Ninth Circuit in *Reno Nat'l Bank* and the decision below are diametrically opposed on the question of federal preemption, there is no conflict because *the end result was the same*: the trust claim was denied. This same result-oriented reasoning lies at the heart of the court of appeals' analysis. Both the Respondent and the court below show a dangerous willingness to compromise important precepts of federalism for the expedient result of maximizing the recovery of the FDIC as the major creditor of Penn Square Bank.

structive trust claims was that the trust claimant had prosecuted its claim and others had not. The language quoted out of context by the Respondent related solely to the fact that the trust claimant had satisfied the requirements for augmentation and tracing, not that the trust claimant had any unique claim as suggested by the Respondent. As in *Fiman*, the Petitioners have proven their pre-failure entitlement to the trust funds and have traced those trust funds into U.S. Treasury bills purchased by the receiver. *Fiman* remains in direct conflict with the decision below in this case because *Fiman* explicitly places the burden on other depositors to prove their claims, not on the trust claimant to disprove the possibly competing claims of others. 29 F.2d at 782.

Similarly, the Respondent failed to diminish the conflict with the Seventh Circuit's decision in *FDIC v. Braemoor Associates*, 686 F.2d 550 (7th Cir. 1982), *cert. denied*, 461 U.S. 927 (1983). Judge Posner held that state law would be applied as the rule of decision in a constructive trust case where, as in the present case, the stated basis for federal jurisdiction and application of federal law was 12 U.S.C. § 1819 Fourth. Judge Posner found a presumption that state law applied due to "the absence of any ready-made federal common law in most of the areas of law in which it might be applied, and a general reluctance to displace state law without explicit statutory or constitutional direction to do so." 686 F.2d at 554. Neither the court of appeals nor the Respondent have shown that such a presumption has been rebutted in this case. No federal common law decision has been cited where a constructive trust claim against a national bank was denied because the property was fraudulently obtained by means of misleading financial statements as opposed to other fraudulent misrepresentations. There is no "ready-made federal common law" in this area. More important, there is absolutely no explicit statutory authority to preempt state law of trusts. Indeed, Congress, not the courts, is the proper authority to determine if a

wholesale elimination of pre-insolvency state law rights is necessary to ensure the expeditious administration of bank liquidations. *See* Pet. 25.

Finally, the Respondent's effort to distinguish the conflicting bankruptcy cases is unpersuasive. As the Petition explains, the decision of the court below creates a different standard for applying the ratable distribution requirement under the National Bank Act than that which is uniformly applied under federal bankruptcy law. Pet. 7-12. The court of appeals' decision is in conflict with the bankruptcy decisions of this Court and a number of circuits on the question of whether state or federal law governs the pre-insolvency creation of a constructive trust. *Id.* The Respondent's brief fails to address this issue head-on. Instead, it attempts to obfuscate the issue by stating that the decision below "merely provides that where *all* creditors are similarly harmed, the assets of the estate should be ratably distributed among all creditors." Resp. Br. 11 (emphasis added). The assertion that all creditors of Penn Square Bank were similarly harmed in this case is demonstrably inaccurate. The largest single creditor, the FDIC, holds almost half of the dollar value of all creditor claims and could not possibly have relied upon Penn Square Bank's financial statements in becoming a creditor.[4] Indeed, the unstated agenda that plainly fuels the FDIC's vigorous opposition is that, by defeating the application of state constructive trust law, it will be able to share ratably in assets that

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[4] The FDIC is a creditor solely as a result of the contractual risk undertaken by the FDIC years before the bank's failure to insure the deposits of Penn Square Bank. The FDIC received premium payments from Penn Square Bank for years to compensate for that risk, and more important, the FDIC undertook to insure Penn Square Bank long before the fraudulent financial statements were ever issued. Thus, aside from the obvious unlikelihood that *all* Penn Square Bank depositors relied on the bank's misleading financial statements, it is clear that the largest creditor of Penn Square Bank could not possibly have relied on the bank's financial statements and therefore could not possibly be "similarly harmed".

properly belong to the Petitioners because the Petitioners, not the FDIC, were defrauded.

In the final analysis, enrichment of the FDIC Bank Insurance Fund at the expense of the Petitioners appears to have been the intended result of the Tenth Circuit's decision. As the Ninth Circuit observed in *Morrison-Knudson Co. v. CHG International, Inc.*, 811 F.2d 1209, 1216 (9th Cir. 1987), and this Court recognized in *Coit Independence Joint Venture v. FSLIC*, 489 U.S. ——, 109 S.Ct. ——, 103 L.Ed.2d 602 (1989), irrespective of the pressing problems of the banking industry, federal courts are not free to effect wholesale revisions of established law in response to current changes in national conditions. That task properly belongs to Congress.

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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